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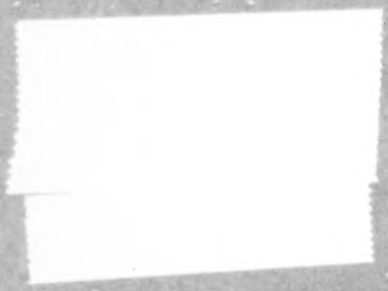
RECENT TRENDS IN CONTRACTUAL PRACTICE RELATING TO ACQUISITION OF SOFTWARE IN THE UNITED STATES OF AMERICA AND THE EEC*

Prepared by

Stanislaw Soltysinski**
UNIDO Consultant



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** Professor of Law, University of Poznan, Poland.

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C O N T E N T S

	Page
INTRODUCTION	1
CHAPTER ONE: THE UNITED STATES OF AMERICA	3
1. General Considerations	3
2. Program Licenses With End Users	4
a) Grant	4
b) Access to the Source Code; Reverse Engineering, Copies and Adaptations	7
c) Tests, Training, Maintenance and Enhancements	11
d) Warranties of Title	12
e) Warranties of Fitness & Merchantability	14
3. "Shrink-Wrap" Licenses	17
4. Sales and Computer Systems Agreements With End Users	20
CHAPTER TWO: RECENT DEVELOPMENTS IN THE EEC	24
1. Introduction	24
2. Licensing of Software and Computer Systems	24
a) General Considerations	24
b) The Scope of the License	25
c) Training, Maintenance and Support	25
d) Responsibility for Legal Defects (Warranties of Title)	26
e) Responsibility for Physical Defects. Warranties of Merchantability and Fitness for a Particular Purpose	27

f) Disclaimers 28

g) "Shrink-Wrap" Licenses 28

3. Sales of Software and Mixed Software/Hardware Transactions 29

a) Problems of Classification 30

b) Warranties for "Physical" Defects 30

c) Remedies for Breach of Warranties and the Impact of General Conditions 31

4. Custom-Made Software and Peculiarities of Contract for Work (Werkvertrag) 33

5. The Implications of the EEC Commission Draft Directive on the Legal Protection of Computer Programs 34

CHAPTER THREE: PROBLEMS PECULIAR TO TRANSNATIONAL TRANSACTIONS 39

1. General Considerations 39

2. Choice of Law and Choice of Forum 40

INTRODUCTION

This report contains a succinct review of recent developments in contractual practice, legislation and case law relating to the acquisition of software in the United States of America and the European Economic Community (EEC). References to practice and case law in other jurisdictions (e.g. in Japan) have been incorporated in footnotes while discussing parallel problems in American or European law. The section devoted to EEC concentrates on recent legal developments at the Community level and in Germany. In addition, the report takes into account contractual practice and case law in the U.K. and France. Furthermore, the report contains a few references to important judicial and legislative developments in Japan (e.g. the issue of legality of "reverse engineering").

Differences between the U.S. and European laws suggested a parallel analysis of analogous problems constituting the main subject of this study. Thus, for instance, the peculiarities of American and Continental rules relating to liability for defective software products dictated somewhat different internal division of the material in the two main segments of the report (Chapter One and Chapter Two). The last chapter is devoted to common problems arising in transnational transactions involving software and computer systems.

In accordance with the terms of the assignment, the report focuses on protection of the recipient (e.g. purchaser, licensee, etc.) of software. In contrast to the majority of available commentaries, handbooks and standard contracts, which are usually prepared under the auspices of suppliers of software or hardware, the report is mainly aimed at helping an importer and user of computer programs. While evaluating typical contractual clauses encountered in standard forms used by the computer industry in the U.S. and the EEC, I have tried to explain their legal consequences and to suggest alternative solutions that could be more advantageous to the recipient of computer technology. However, one must bear in mind that the legal "know-how" constitutes only one prerequisite for a successful deal and it cannot counter-balance disparities in bargaining powers between providers of software and their clients from developing countries. At the same time, an in-depth knowledge of the relevant contractual practice and applicable law is an important factor in negotiations.

A computer program may be acquired and disseminated in a number of ways. The limited scope of this report dictated the need of narrowing it to three main categories of such agreements, namely, "sales", "licenses" and "software development contracts" (commission contract, Werkvertrag). It is further assumed that the foregoing agreements are concluded between computer companies and end-users of software. International distribution and representative agreements are beyond the range of this analysis. In principle, the report is limited to "pure" software transactions but several references are made to case law applicable to "mixed" contracts which cover both software and hardware products.

The report focuses on three substantive aspects of software acquisition contracts: 1) the scope of the software recipient's right to use the acquired technology, 2) responsibilities of the supplier for legal and technical defects of software, including tests and guarantees and 3) the recipient's contractual

remedies against the supplier for malfunctioning of defective software. Special attention is paid to contractual devices aimed at limiting or excluding supplier's liability in the foregoing areas. In addition, the paper scrutinizes problems arising in the context of the so-called "shrink-wrap" licenses and analyzes the dispute concerning the legality of "reverse engineering" (decompiling) of computer programs. Issues common to all transfer of technology transactions, such as fees and other forms of payments, term and termination of the agreement, non-competition and non-assignment clauses, are outside the parameters of this analysis.

CHAPTER ONE: THE UNITED STATES OF AMERICA

1. General Considerations.

The difference between "sales" and "licenses" seems to be rather clear. The former contracts consist in transferring the title to "goods" while license agreements are merely permissions to use intangibles by licensees within the limits and on terms agreed upon between the parties to a license contract. In the context of software acquisition contracts this distinction is blurred. First, it is by no means clear whether computer programs are "goods" within the meaning of Art. 2 of the Uniform Commercial Code (UCC) which governs sales transactions in all States, except Louisiana. Second, the owners of software rarely transfer all rights in their intangibles. Normally, they prefer to recoup their investments and profit therefrom by way of granting limited permissions to use the licensed programs to more than one user. License agreements allow them not only to maximize profits but also to limit potential competition from recipients of their software. Hence, the owner of a computer program usually wants to retain some proprietary rights in order to get access to improvements, control future developments of the disseminated software, etc.[1] When the supplier retains some indicia of ownership in software, the demarcation line between "sales" and "licenses" is not clear. Third, "pure" software transactions are less common than "mixed" contracts involving hardware, software and supporting services.

For reasons stated above, recipients of software should be aware of the implications of the choice between "sale" and "license" form of the transaction. An importer of software should explore the possibility of "purchasing" rather than obtaining a right to use the target software. Because copyrights and intellectual property rights in trade secrets in a specific computer program constitute a bundle of territorially divisible rights, an importer may sometimes persuade an exporter to sell him software within the borders of the purchaser's country. Similarly, in a border-line case when the supplier of software retains some indicia of title, the recipient should try to insert a clause explaining that the title has passed to the purchaser and the stipulations in favor of the supplier are of purely contractual nature.

Disputes concerning legal characterization of a given transaction ("sale" or "license") are of particular significance with respect to "packaged" software which is commonly marketed in the "license" form. Courts and commentators agree that it is the content of the legal relationship rather than the denomination of the transaction by the distributor which should be taken into account in disputable cases.[2]

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[1] Schachter: Product Acquisition Agreement: A Form Contract With Alternative Clauses; Association of Data Processing Service Organizations, hereinafter "ADAPSO", (1983), at (i).

[2] Careful characterization of a given transaction is very important in transnational agreements to avoid its wrong classification under foreign and domestic transfer of technology regulations, tax laws, etc.

2. Program Licenses With End Users

a) Grant

The term "license" suggests that a licensor is the holder of an exclusive right in the licensed information. It is also presumed that the licensed software is the property of the licensor. The term "property" in this context denotes copyright or proprietary trade secret. Occasionally, a computer program can be protected by a U.S. patent. Most computer programs are protected concurrently by federal copyright and state trade secrets laws. Such cumulative protection of technology information provides the cheapest and the most effective form of guarding the interests of the licensor. Copyright protection of binary form enhances trade secret protection of underlying non-copyrightable ideas and procedures.[3] And despite obvious conflicting objectives of these two forms of legal protection and notwithstanding the preemption of all legal rights "that are equivalent to any of the exclusive rights that are within the general scope of copyright", the majority of recent precedents shares the opinion according to which a trade secret claim is not **pre-empted** by federal copyright law.[4] And although the purpose of copyright laws has been public access to information and the "dissemination of ideas"[5], at present both courts and the U.S. Copyright Office reconcile copyright formalities with assertions of trade secrets rights. By permitting secret deposits of computer programs, the Copyright Office has become an agency collaborating with proprietors of software to bar public access to non-copyrightable ideas (e.g. algorithms) i n d e f i n i t e l y.[6]

The demise of the supremacy of federal competition law over intellectual property exclusive rights in the present case law permits the licensor of software to grant both temporary and p e r p e t u a l licenses. While a copyright license shall not exceed the term of the monopoly right, assertion of trade secrets rights in the licensed software justifies licenses of i n d e f i n i t e duration. Computer industry standard forms indicate that

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[3] Davidson: Reverse Engineering and the Development of Compatible and Competitive Products Under United States Law, 5 Santa Clara Computer & High Technology Law Journal, 399,410 (1989).

[4] See Warrington Ass. Inc. v. Real Time Eng. Sys., Inc., 522 F. Supp. 367 (N. D. Tex. 1981); BPI Sys., Inc. v. Leith, 532 F. Supp. 208 (W. D. Tex. 1981). Contra: Videotronics, Inc. v. Bend Electronics, 564 F. Supp. 1471 (D. Nev. 1983). In the latter case the court denied trade-secret protection on the grounds that "a property which is subject to protection under federal patent or copyright law cannot also obtain the benefit of protection under either state unfair competition or misappropriation law" Id. at 1476.

[5] Harper & kow, Publishers Inc. v. Nation Enters., 471 U.S. 539, 545-546 (1985).

[6] See further Soltysinski: Legal Protection for Computer Programs, Public Access to Information and Freedom of Competitive Research and Development Activities, 16 Rutgers Computer and Technology Journal, 447, 467 (1990).

"there is no case or other precedent holding that proprietary or trade secret protection will not be enforced if the license is perpetual."[7] Some commentators advise against perpetual software licenses arguing that such contracts may be treated by courts as "sales" or may be held invalid because of antitrust considerations.

It is clear from the above that suppliers of software are almost completely free to shape the content and scope of their permissions to use licensed software. Apart from time and geographical limitations, software licenses frequently restrict the permissible u s e to a single computer specified in the agreement by its serial number or in the location designated therein. A typical standard form reads as follows:

> Client shall have the right to use the Licensed Program and materials solely for its own internal operation in the location designated in this Agreement, (or, only in the installation designated in this Agreement, or only on the computer [or machine] designated in this Agreement)[8]

As an alternative to restricting a grant to a single location or a specified machine, the parties may agree on a uniform company-wide license permitting the licensee to use the program on each of its computers. Large corporations prefer to negotiate for a single license covering all their hardware installations.

IBM's current "Terms and Conditions for Licensed Programs" also restrict the use of a program on the designated machine but, in addition, they permit the customer inter alia to:

> copy or translate the Program's machine readable portion into any machine readable or printed form to provide sufficient copies to support the Customer's authorized Use of the Program; and modify and/or merge the Program's machine readable portion with other programs to form an updated work for the Customer's own use .....

In the event the licensee is authorized to use the licensed program only on a single machine, he should try to negotiate a special permission in typical contingency situations involving inoperability of the designated computer or the need to transfer the installation to a new location.[9] Likewise, a prudent licensee should try to negotiate a permission to transfer the licensed programs to another location or to another designated CPU. Bingelow recommends the following standard clause:

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[7] Schachter: Program License Agreement With End User. A Form Contract With Alternative Clauses, ADAPSO (1979), Section 7.

[8] Id. at 7.

[9] A frequently negotiated "temporary use" license clause reads: "Client is authorized to transfer the license and to use the licensed Program on a back-up computer when the designated computer is temporarily inoperable until operable status is restored and processing on the back-up machine is completed". Id. (ADAPSO standard forms).

> Upon thirty days written notice to Licensor, Licensee may transfer the Licensed Programs to another Designated CPU on a date specified. Such notice shall specify the date of transfer and thereafter the designated CPU shall be the CPU designated in such notice.[10]

As already mentioned, software licenses are normally limited to the licensee's internal use or operation. This limitation is usually further defined in the agreement. **In Systems Development Corp. v. U.S.**[11], the pertinent clause read:

> The National Library of Medicine agrees not to utilize licensed material in the performance of computer service bureau operations nor performance of any services for third parties except within its mission as established by law or regulation.

The court interpreted strictly this ambiguous clause and held that the Library did not violate the terms of the license by providing data to hospitals, universities, etc. Such use of the licensed software was not viewed as providing computer service bureau operations.

An importer of a computer program that contemplates using the software both in its own company and with the help of third parties is recommended to adapt a flexible clause found in a US - Canadian licensing agreement:[12]

> The use of the licensed software is to be confined to the Licensee. This License may be exercised by the Licensee by having the Licensor install an operating version of the Licensed Programs on the Licensee's own computer or on such other computer of suitable capacity as may be selected by the Licensee, provided a non-disclosure and confidentiality agreement is first entered into between the owner of such other computer and the Licensor.

Such a clause may be very helpful to an importer from a developing country who wants to benefit from the acquired software without the need to make his own capital investment in more expensive hardware.

A careful licensee should also try to negotiate the right to use the licensed software for the internal requirements of its affiliates. The key terms "use" (or "internal requirements") and "affiliates" require precise definitions in the

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[10] Bingelow: Computer Contracts Negotiating and Drafting Guide, vol.2. form 8.03-1[3] (1989).

[11] 531 F.2d 529 (Ct. Cl. 1976).

[12] Id., clause 3(b). Bingelow adapted the language of the license agreement between Com/Code Corporation of Washington D.C. and the St. John Shipbuilding & Dry Dock Co. Ltd. of Saint John.

agreement.[13]

b) Access to the Source Code; Reverse Engineering, Copies and Adaptations.

An important issue in software licensing negotiations is whether the licensor is obliged to provide the licensee with the **source code** and documentation describing the structure or functioning of the program. Licensors prefer to license only an object code and "as little documentation as possible, so that it will be difficult for the licensee to reverse engineer the software to reveal any trade secrets".[14] Following the policy of IBM, the industry leader, the majority of licensors normally expressly prohibit the licensee's access to source codes.[15] Such express contractual prohibitions are aimed at avoiding the impact of the doctrine of "fair use" and other permissive provisions of the Copyright Act (1980).[16]

By contrast, the licensee will be always interested to receive the source code, without which it is practically impossible to modify, enhance or even to remove defects of a licensed program. Licensing a source code is sometimes indispensable. For instance, in an agreement where a software developer licenses a distributor (e.g. a software house or a computer hardware producer), the latter party is usually responsible for continuing obligations consisting in adaptation of the licensed software to the needs of end-users of the product, removing defects and, often, enhancing the original program. But in the context of a license with an end-user, the licensee interested in obtaining access to the source code is usually required to pay an extra fee and accept specific obligations aimed at assuring confidentiality of the code and any information related thereto. Standard contracts dealing with the issue of confidentiality of licensed materials and information embrace both the officers of the licensee and its employees. Bingelow[17] suggests the following formulation:

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[13] The following definitions are recommended by Schachter, *supra*, note 1, at 3-4: "The term 'use' shall include copying any portion of the licensed materials into a computer or transmitting them to a computer for processing of the instructions or statements contained in the licensed program or materials". The term "affiliates" is defined as "any corporation controlling or controlled by Licensee or controlled by a corporation which also controls Licensee". For the purpose of the preceding sentence "control shall mean the ownership of more than 50 percent of the outstanding capital stock or other equity interest".

[14] Sobel, Einhorn: Software Protection and Licensing (in: Technology Licensing 1989, ed. Sobel), at 403.

[15] Notice to IBM Customers of February 8, 1983, International Business Machine Corporation, White Plains, NY.

[16] See, for instance, the 1976 Copyright Act, as amended, 17 U.S.C. && 107, 109 and 117 (1980).

[17] *Supra*, note 10, form 8.03-1, Cl. 14.

> Licensee agrees that the source code licensed under this schedule S is the property of and a trade secret of [Licensor]. Licensee agrees not to reveal the source code to any person or entity, except as otherwise provided herein, nor shall Licensee reveal to any other person or entity directly or through its employees any information relating to the source code, the programming therein, or the algorithm thereof.

Some licensors require from licensees that their officers and employees having access to confidential data must execute special confidentiality covenants. Furthermore, licensees are frequently bound to pay agreed damages for breach of such stipulations and the agreed liquidated damages may be higher than the total cost of acquiring the license.

Licensees who receive object codes only become completely dependent upon the licensor not only for future enhancements and modifications of the program but also in the event of software malfunctioning. Access to the source code of a licensed program is crucial in case of importation of foreign software when the distance between the licensee and the licensor makes it difficult to have the licensor's experts available in the country of the situs of the user. Special hazards exist when software is acquired from small software houses that may become bankrupt, thus enabling creditors to attach all unsecured property of the licensor.

A standard compromise solution for such contingencies consists in appointing an **escrow** agent, with whom the licensor will deposit the source code and its subsequent modifications. Under such an escrow agreement, the licensee has the right to obtain access to the deposited code in the events specified in the agreement, for instance, if the licensor stops maintaining the licensed program, refuses to deliver the modifications thereof or files a petition in bankruptcy. Such an arrangement reduces the risk of destroying secrecy while affording the necessary protection for the licensee. A standard form elaborated under the auspices of ADAPSO recommends the following language of the Source Program Escrow clause:

> ABC will deposit and maintain with an escrow agent a current copy of the source code of the Licensed Program. In the event ABC ceases to carry on business or ceases to provide maintenence for the Licensed Program, the source code will be provided to client.[18]

In 1985, a bankruptcy decision in which the court permitted a bankrupt licensor to reject its nonexclusive license to a licensee was interpreted as a precedent that could preclude the usefulness of the escrow agreements.[19] Soon

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[18] *Supra*, note 1, at 47 .

[19] Lubrizol Enterprises Inc. v. Richmond Metal Finishers, Inc., 756 F.2d 1043 (4th Cir. 1985), cert. denied, 475 U.S. 1057 (1986). By allowing to reject the license, the court left the licensee without the right to use the licensed invention. Although the license dealt with a metal coating technology, its rationale applied to all executory licenses and the majority of software licenses belong to this category.

afterwards, the U.S. Congress passed a corrective legislation which reiterates the validity of escrow rights in the field of intellectual property. Intellectual Property Bankruptcy Protection Act states that if the bankruptcy trustee "rejects" a license, then the licensee may either treat the rejection as a termination and submit a claim for a breach of contract or retain its license, continuing to make royalty payments to the estate. The trustee must not interfere with the licensee's right to obtain copies of intellectual property technologies (e.g. a source code) but there is no obligation of maintenance or support on the part of the bankrupt estate in such a situation.[20]

Industry standard forms for software licenses with end users often contain express prohibitions on **reverse engineering, modifications and adaptations** of software. Reverse engineering is the process by which a product embodying an innovation is analyzed by a competitor in order to study or to reproduce thereof for competitive purposes. While such inspection is perfectly legal in all other areas of intellectual property,[21] hybrid protection of software under trade secret and copyright laws enables the software developers to argue that decompilation and disassembling of computer programs amount to an illegal copying of the protected form of software. Since the law in this field is not settled, suppliers of software can afford to preclude reverse engineering and modifications of the licensed software by inserting express contractual prohibitions into their agreements with licensees.

It is interesting to note that prior to its 1983 announcement,[22] IBM apparently tolerated decompilation and adaptation of its software. Since then, however, the company's ban on reverse engineering has become an industry legal standard. "Agreement for IBM Licensed Programs" provides that a licensee (customer) shall not reverse, assemble or decompile in whole or in part any licensed program.[23]

While judicial authorities and commentators are divided on the issue of legality of "reverse engineering" in the area of "copyrighted" software, the licensors of computer programs may also rely on contractual bans enforceable

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[20] P.L. 100 -506. 11 U.S.C. & 365(n)(2) (1989).

[21] See Kewanee Oil Co. Bicron Corp., 416 U. S. 470, 476 (1974). Recently, the Supreme Court noted again that "the competitive reality of reverse engineering may act as a spur to the inventor, creating an incentive to develop inventions which meet the rigorous requirements of patentability." Bonito Boats, Inc. v. Thunder Craft Boats, Inc.109 S. Ct. 971, 982 (1989).

[22] *Supra*, note 15.

[23] Id. A clause drafted by Bingelow goes even a step further: "Licensee shall not decompile, disassemble, or reverse engineer the Licensed Programs or any of them, or attempt to do so." *Supra*, note 10, FM 8.0-1 cl. 3(d).

under state laws. While CONTU Report[24] and some recent cases[25] suggests that it may be a "fair use" under Section 107 of the Copyright Act to make a printout copy of software for purposes of making modifications and other purposes, there is no judicial authority questioning the validity of contractual prohibitions on reverse engineering in arms-length licenses.

As a rule, software license agreements with end users strictly control the number of **permissible copies** of each licensed program and other proprietary materials supplied to the licensee. Restrictions on the number of authorized copies the licensee can make during the agreement cover not only source codes but also object codes, manuals, instructions, etc. Licensee is permitted to make one copy of each program for back-up purposes **(archival copies)**. In the event of loss or accidental destruction, he may obtain an extra copy subject to an additional payment. Frequently, licensees are obliged to observe special measures aimed at assuring compliance with confidentiality obligations:

> (a) **COPIES**. As provided in Clause 3(c), Licensee may make copies of the Licensed Software, provided that each such copy shall state that it is the property of Licensor , ..., in the following language:
>
> "this copy of ....[insert the name of program or manual] is the property of [insert the name of the Licensor] ...., as their interests may appear and is protected under the copyright, trade secret and confidentiality laws of the United States and Canada. At Licensee's request, Licensor will provide a label to be attached to the copy setting forth the foregoing statement. Licensee shall keep a record of each copy made, where such copy is located and in whose custody it is. The provisions of this clause shall apply to all licensed Software, including without limitation programs, manuals, instructional materials and all other documentation provided to Licensee."[26]

Practical significance of such contractual steps to protect the confidentiality of the information licensed cannot be overestimated. The problem is illustrated by **Data General Corporation v. Digital Computer Controls, Inc.**[27] The plaintiff alleged misappropriation of its proprietary information embodied in maintenance drawings for a Nova 1200 minicomputer which had the following legend:

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[24] National Commission on the New Technological Uses of Copyrighted Works ("CONTU"), pp.31-32 (1978).

[25] See, for instance, NEC Corp. v. Intel Corp. N. 67, 434 (N.D. Cal. Feb. 6, 1989). The court refused to condemn the disassembling and listing of an Intel microcode for the purpose of analyzing it and making a competitive program. Contra: Apple Computer , Inc. v. Franklin Computer Corp., 714 F. 2d 1240 (3d Cir. 1983).

[26] Bingelow *supra*, note 10, Form 8.03-1 (Cl. # 4(a)).

[27] 357 A 2d 105 (Del. Ch. 1975).

> This drawings and specifications, herein, are the property of Data General Corporation and shall not be reproduced or copied or used in whole or in part as the basis for manufacture or sale of the items without written permission.

It was rather surprising, even in the context of the present generous attitude of the U.S. judiciary vis-a-vis proprietors of trade secrets, that the court ruled for plaintiff despite of the fact that the pertinent maintenance drawings had been made available to about six thousand people and the mass distribution of the alleged secrets by the proprietor did not destroy its claim for trade secret protection.

c) Tests, Training, Maintenance and Enhancements.

As explained in IBM's "Terms and Conditions for Licensed Programs", the purpose of a **trial period** is to allow the customer to determine that an acquired program meets its requirements. A trial period may be either a **Testing Period** or a **Return Period**. Where the former applies:

> The Customer may use the Program only for non-productive purposes during this period to determine that it meets its requirements.....
> The Customer may terminate the License upon written notice, effective immediately, at any time, during the testing period, in which event [charges specified in the Agreement] will not be due. However, process charges, if any, will be due.

Where a **return period** applies, the licensee may return the licensed program but it must end the agreement by written notice because:

> Unless such notice of termination is given, the customer will be deemed at the end of the trial period to retain the Licensed Program under the provisions thereof.

According to a survey conducted by ADAPSO among its members, an agreement between a software company and an end user is the most frequent type of licensing contracts, although some software licenses and industry standard forms characterize "program support services" as optional. According to the same source, such services are usually included with the license at no extra cost.[28] Among the services most frequently offered free of charge are installation, training or maintenance. A license contract will usually specify the scope of such additional services to be rendered at no extra charge during the term of the agreement. The following sample clauses illustrate the practice:[29]

> [Licensor] will provide up to ... days of training (or, operator instruction to ... [number of persons] designated by [Licensee]) in the use of the licensed Program and Materials (on Client's computer equipment).

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[28] Schachter, *supra*, note 1, at 9.

[29] All examples taken from ADAPSO Sample Forms, note 1 *supra*, at 10-13.

> [Licensor] will provide maintenance of the Licensed Program for a period of .... month(s) (or, year(s)) from the date of delivery (or, date of installation) of the Program (and Materials).
>
> Upon written request, Licensee will provide, for a period of month(s) (year(s)) after execution of this Agreement (or, after delivery of installation of the Licensed Program and Materials) enhancements to the Licensed Program [and Materials] that are marketed by Licensor.

Characteristically, software industry standard contracts often provide clauses to the effect that any unauthorized enhancement to a licensed program by licensee deprives him of the benefit program support services. **"Software product maintenance and support agreements"** frequently constitute a separate part of a software acquisition contract. In such cases, they provide for additional fees to be paid by the licensee. Sometimes, suppliers of comprehensive computer systems covering the delivery of software and hardware insist on executing a legally autonomous maintenance and support contract that becomes effective after the installation of the system. The separation of a basic software acquisition contract from its functionally related "maintenance and support" agreement may be dictated by various factors (e.g. tax considerations, requirements of foreign technology control laws, inability of the main supplier to undertake extensive support obligations, etc.). The licensee may prefer to enter into a separate software program maintenance agreement with a third party in the event when the recipient of technology is in direct competition with the licensor and does not want its commercial secrets to be disclosed to the personnel of the competitor. Similarly, the licensee may prefer to order an installation and training services from the actual developer of a licensed program, who is more familiar with the technology than the licensor, who acquired the title to the licensed software from the programmer.

The **maintenance and support** agreements usually mean removal of programming errors, maintaining a licensed program operational in conformity with specifications, supplying licensee with updated user guidelines and updates to the licensed programs. In addition, the licensee may be also authorized to request **"enhancements"** of the original software. Some sample contracts carefully distinguish between **"updates"** and **"enhancements"**.[30] Because some program maintenance and support obligations overlap with warranty obligations (e.g. correction of errors), some aspects of a licensor's duty to remove defects of software will be discussed in the Sub-Section e) below.

d) Warranties of Title.

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[30] A sample contract elaborated under the aegis of ADAPSO defines "updates" as "program logic and documentation changes and improvements to correct known defects and maintain the operational quality of the Licensed Program", while "enhancements" mean "any program, any part thereof or any materials not included in the Licensed Program and Materials at the time of execution of the original License Agreement ... that is developed for the Licensed Program." They usually cover an added function to the originally licensed program. Desrosiers, ADAPSO Product Maintenance Agreement, & 1.05 (1983).

In view of the uncertainties associated with the legal status of software programs, licensors are reluctant to grant express warranties of title and tend to limit their potential liability by way of contractual disclaimers.[31] Foreign licensees should be aware that standard warranties of property rights employed by American licensors offer them a minimum of protection and should not be confused with comprehensive warranties of title. Thus, for instance, a promise that licensor "warrants that it has the right to grant a license to the licensed program", may be interpreted merely as an assurance that the licensor has obtained the authority to license from a third party, for instance, the developer of the licensed computer program. Such clauses are used also by program developers who wish "to guarantee what is minimally necessary to ensure the legality of the license grant".[32] Therefore, the licensee is advised to check the validity of the licensor's authority or to demand a stronger legal guarantee to title ostensibly owned by the supplier.

A warranty of software development by the licensor is also a very weak form of guarantee. It simply means that the licensed program was conceived by the licensor but the latter does not guarantee that the software does not infringe third party intellectual property rights. Therefore, a licensee with a strong bargaining power or a "deep pocket" may try to obtain both an express guarantee of title and indemnity in the event of infringement of third party rights. Such a double protection scheme can be drafted along the following lines:

> Licensor warrants that it is the sole owner of the licensed software that is free of any third party rights (e.g. liens, encumbrances, etc.). The licensor further warrants that, to the best of its knowledge, its proprietary rights are not challenged or disputed by any third party. In the event of a claim that the use of the licensed program constitutes an infringement of a third party right, the licensor will indemnify the licensee from all direct and consequential damages.

Realistically, however, the chances of obtaining such protection by a licensee are often marginal. A sensible compromise may consist in combining an assurance that the licensed program does not violate third party rights (to the best of licensor's knowledge) with a promise to defend licensee in the event of a challenge by such parties. Consider the following sample clauses prepared under the auspices of ADAPSO:

> In the event of a copyright or patent infringement claim, [Licensor] may at its own expense defend such claim or may procure the right to continue using all or part of the Licensed Program or may discontinue the Licensed Program. This shall constitute the entire liability of [Licensor] with respect to a copyright or patent infringement claim.[33]

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[31] Disclaimers of warranties are discussed in sub-section e) *infra*.

[32] Schachter *supra*, note 1 at 33. A similar comment is made by Bingelow, who is of the opinion that such warranties mean that the licensee is only indirectly liable for failure to have title. *Supra*, note 10, Form 8.03-1, Cl.5.

[33] Schachter, *supra* note 1, at 35.

> In the event of a claim that the Licensed Program constitutes an infringement of a copyright or patent, [Licensor] will indemnify [Licensee] from direct expenditures incurred by [it] in defense against such claim, provided that [Licensor], in its judgement, shall receive the cooperation and assistance of [Licensee].[34]

Note that in both instances, the licensors' liability is limited to patent and copyright infringement suits while a license can be attacked for violation of proprietary information. Second, the first clause gives the licensor a full discretion whether to defend a third party challenge. In the second sample, the licensor may avoid liability arguing that the licensee has failed to provide him sufficient assistance. Therefore, a judicious licensee should be able to distinguish between limited but meaningful warranties from sham and discretionary assurances. Therefore, for instance, the parties should agree on the scope of cooperation while defending third party suits.

Some major computer firms, notably IBM, grant their customers very effective warranties of title. Standard Terms and Conditions used by that company read as follows:

> IBM will at its own expense settle or defend, and pay any damages or costs resulting from, any claim brought against the customer that any machine, program package or programming or the use of any material within the scope of a License or any use thereof infringes or has infringed a patent, design right ..., moral rights copyright or any intellectual property right effective in the U.K. provided that the customer:
>
> (i) promptly notifies IBM in writing of any such claim; and
> (ii) permits IBM to control the defence and settlement of any such claim.

e) Warranties of Fitness and Merchantability.

Implied warranties of **fitness** for a particular purpose and warranties of **merchantibility** of software roughly correspond to statutory liability for "physical" defects of goods in civil law countries. As in Europe and Latin American countries, the threshold problem is whether code provisions governing the seller's liability for defective performance are applicable to transactions involving software. Two arguments are advanced against the application of Art.2 of the Uniform Commercial Code on Sales to licensing of software. First, software is not "good" within the meaning of & 2-105 because software is an intangible. Second, software licenses are not "sales" because the title to the intangible remains with the licensor.[35]

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[34] Id.

[35] Durney: The Warranty of Merchantability and Computer Software Contracts: A Square Peg Won't Fit in a Round Hole, 59 Washington Law Rev., 512-515 (1984).

Objections against applying traditional sales law concepts have gradually faded away. Today, the majority of commentators agree that the UCC provisions on warranties should govern either directly or by way of analogy the obligations of suppliers of software vis-a-vis their clients. A recently published handbook concludes that Art. 2 of the UCC governs most computer-related transactions, except those that can be characterized as contracts for rendering solely services.[36] Judges and parties to software legal disputes tend to rely on the Code, because the standards established in Art.2 constitute the only comprehensive codification of warranties in business transactions. Efforts to pass special legislation devoted to the liability of suppliers of software have failed due to the lobbying of the industry.[37]

Since courts and legal commentators tend to treat essentially equally various forms of transactions in software and in reality, software licenses are often merged with transactions for the delivery of hardware and services (e.g. computer system agreements or "turn-key" computer contracts), a more comprehensive description of legal consequences of the subjection of the said computer software deals to Art. 2 of the UCC, is presented in Section 4 (*infra*). Below, are presented briefly legal standards prevailing in the U.S. licensing practice.

According to an industry survey, the warranty clauses belong to the most frequently negotiated contractual stipulations. Yet, at the same time, the content of warranty clauses used by members of ADAPSO reveals that these clauses are strikingly similar. It proves that the clauses are "so to speak non-negotiable".[38] A review of warranty stipulations used by the industry leaders and recommended by leading software law handbooks indicates that, with the sole exception of **custom-made programs**, licensees can rarely count on obtaining a bare minimum of guarantee that a licensed program either fits for a particular purpose or that its operation will be substantially error-free. For example, A program license agreement for IBM's 2.1 DOS reads:

> LIMITED WARRANTY: THE PROGRAM IS PROVIDED "AS IS" WITHOUT WARRANTY OF ANY KIND, EITHER EXPRESSED OR IMPLIED, INCLUDING, BUT NOT LIMITED TO THE IMPLIED WARRANTIES OF MERCHANTABILITY AND FITNESS FOR A PARTICULAR PURPOSE. THE ENTIRE RISK AS TO THE QUALITY AND PERFORMANCE OF THE PROGRAM IS WITH YOU. SHOULD THE PROGRAM PROVE DEFECTIVE YOU ... ASSUME THE ENTIRE COST OF ALL NECESSARY SERVICING, REPAIR OR CORRECTION ... IBM does not warrant that the functions contained in the program will be uninterrupted or error-free. However, IBM warrants the diskette(s) or other medium on which the program is furnished, to be free from defects in materials and

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[36] Simon: Computer Law Handbook: Software Protection Contracts Litigation Forms, at 64-65 (1990). Compare also Rodau: Computer Software: Does Art. 2 of the UCC Apply? 35 Emory Law Journal 853 (1986).

[37] A bill proposed in California to require specific software warranties was withdrawn after opposition of the software industry. See Section of Patent, Trademark and Copyright Law (1987). Special legislation validating "shrink-wrap" licenses was passed by two states. See *infra* Section 3.

[38] Schachter, *supra* note 1, at 28, footnote 1.

> workmanship under normal use for a period of 90 (ninety) days from the date of delivery to you...LIMITATIONS OF REMEDIES: IBM's entire liability and your exclusive remedy shall be: the replacement of any diskette ... if IBM or the dealer is unable to deliver a replacement ... which is free of defects ... you may terminate this agreement.[39]

The foregoing contractual provision, which follows Art. 2 requirements concerning warranty exculpation clauses, contains the notorious **"as is"** disclaimer excluding all implied warranties. According to & 2-316(3)(b) of the Code, such expressions like **"as is" or "with all faults"** exclude all implied warranties which means that the buyer (licensee) takes the entire risk as to the quality of the goods. Foreign importers of software should be also aware that by examining the computer system or refusing to examine the licensed program, they may lose implied warranties "with regard to defects which an examination ought in the circumstances to have revealed to [them]" (& 2-316(3)(b)).

Against this backdrop, licensees ought to try to negotiate a meaningful protection with respect to the reliability of program performance and its fitness to a concrete purpose. The two sample clauses reproduced below seem to represent a compromise approach:

> Licensor warrants that the Licensed Program shall perform in accordance with the specifications set forth in the licensed materials and fits the purpose described in the "whereas" clause.
>
> Licensor warrants that the licensed program will perform substantially in the manner described in the licensed materials if it is properly used as described in the instructions and manuals delivered to Licensee.

It is worth noting that the latter clause contains two important qualifications in favor of the licensor. The word "substantially" takes into account the legitimate interests of the licensor. Indeed, there are no perfect error-free programs and they are constantly modified. Therefore, parties to a licensing agreement should negotiate a program of long-term cooperation aimed at both removing defects and perfecting the licensed software.[40]

A discerning licensee should describe in detail the intended use of the computer program to be acquired and obtain precise information from the licensor concerning the advantages of his software, its compatibility with the user's

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[39] Note that the disclaimer language is in block letters to meet the requirement of the UCC that the exculpatory clause shall be "conspicuous" in the contract.

[40] ADAPSO sample forms recommend, for instance, the following clause:
"During the period the Licensed Program is under warranty, [Licensor's] sole obligation will be to correct technical errors or failures ... in the Licensed Program of which the Licensee notifies in writing .... This service will be rendered without charge ..., except for the costs incurred by Licensor for machine time, software delivery, medium ... and reasonable travel and per diem maintenance costs ...". Schachter *supra*, note 1, at 31.

hardware, etc. The licensor's explanations, especially given in business correspondence, may be classified as **"express warranties"**. Licensors, however, try to disclaim liability for inducing their clients to enter into contracts by relying on the **parol** provision of & 2-202 of the UCC, **disclaimers** and the so-called **merger** clauses. Consider, for instance, the disclaimer and merger clause in **Investors Premium Corp. v. Burroughs Corp.**[41]:

> There are no understandings, agreements, representations or warranties, express or implied (including any regarding merchantability or fitness for particular purpose) not specified herein, respecting this contract or the equipment hereunder. This contract states the entire obligation of the seller in connection with this transaction.

The purpose of such a merger clause is to negate an express warranty, usually given before execution of the contract but, sometimes, it is used to disclaim even a warranty given after signing the agreement. Commentators stress the fact that the majority of U.S. courts usually approve the validity of such disclaimers embodied in merger clauses.[42] The first precedent in the computer transaction field that explicitly rejected the proposition that disclaimers are effective against express warranties was **Consolidated Data Terminals v. Applied Digital Data Systems.**[43] Although those cases dealt with computer hardware and computer systems, it is likely that their holdings are applicable to **"mixed"** (software-hardware) and "pure" software transactions.

3. Shrink-Wrap Licenses.

The development of personal computers, combined with the ability of software firms to distribute programs on floppy disks, have enabled them to market software in small packages. Typically, such programs are recorded on diskettes and marketed in plastic envelopes containing both software and instructional material. Although the distribution of programs is analogous to selling books, software companies have chosen a **license form** of contract in order to protect their trade secrets and control the market. The advantages of the license approach are manifold: First, software owners are able to retain title to the program and the medium in which the software is recorded. Second, they can unilaterally delineate the scope of the client's right to use the program and disclaim all warranties. Third, perhaps they can even defeat those provisions of the Copyright Act which are aimed at securing the owner of a copy of a program the right to make **adaptations** and the right to make a **back-up copy**. The retention of title enables the owner of software to prevent reverse engineering and avoid the application of the First Sale Doctrine that prohibits the copyright owner to control copies of books and other works which were sold in a market place.

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[41] 389 F. Supp. 45 (D.S.C. 1979).

[42] Chretien-Dar: Uniform Commercial Code: Disclaiming the Express Warranty in Computer Contracts, 40 Oklahoma Law Review, 471 et seq.(1987).

[43] 708 F. 2d 385 (9th Cir. 1983). The case dealt with a conflict between an express warranty concerning the speed of a line of terminals acquired by plaintiff and a general disclaimer in the contract.

"Shrink-wrap" licenses, also known as **"blister-pack"** or **"box top"** licenses, are typical **contracts of adhesion**. Unlike arm's-length license agreements, they leave no room for negotiations and, according to their terms, the contract is made upon the opening of the package containing a program by the client. An offer to clients printed on the wrapper typically reads as follows:

> BEFORE YOU OPEN THIS PACKAGE: CAREFULLY READ THE FOLLOWING LEGAL AGREEMENT REGARDING YOUR USE OF THE ENCLOSED PROGRAM. OPENING THIS PACKAGE MEANS YOU ACCEPT THE TERMS AND CONDITIONS OF THIS LICENSE. IF YOU DO NOT AGREE WITH THEM, YOU SHOULD RETURN THE PACKAGE UNOPENED AND YOUR MONEY WILL BE REFUNDED.

Some software companies try to obtain the customer's signature by providing a registration certificate which may allow the "licensee" to claim his money back or enforce skeleton warranties but many software "publishers" do not bother to obtain such evidence of the client's assent. Typical terms of shrink-wrap licenses used by suppliers of such popular programs as Lotus 1-2-3, WordPerfect, Apple Writer usually contain the following terms and conditions: 1) the geographical scope of the license is limited to the territories of the United States and its possessions; 2) the licensee is permitted to use the program on a single machine; 3) the transfer of the program is prohibited or conditioned upon the acceptance of the terms of the license by the sublicensee; 4) reverse engineering and adaptations of the program are usually prohibited[44]; 5) programs are normally licensed on **"AS IS"** basis, that is to say "without warranty of any kind"[45]; 6) licensors disclaim any damages but, sometimes, licensees are allowed to claim the replacement of a defective medium (e.g. diskette) or they may obtain a refund upon returning the program if the licensor or its dealer is unable to deliver a replacement; 7) to further protect the licensor and its dealer against the risk of express warranties arising during negotiations or discussions preceding the agreement, shrink-wrap licenses contain **"merger"** or **"entire contract clauses"** which state that the licensee acknowledge that he has read the contract and agrees that the agreement "supersedes any proposal or prior agreement, oral or written, and any other communications between [the Parties] relating to the subject matter ...."[46]

The phenomenon of shrink-wrap licenses has been analyzed in numerous law reviews and many commentators stress the fact that they epitomize all vices of contracts of **adhesion** allowing the party of superior bargaining strength to dictate its terms unilaterally to its clients.[47] Recognizing that courts may

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[44] But some licenses permit making a back-up copy, modification and merging of the licensed software into another program used by the licensor for its internal purposes.

[45] Bingelow, *supra* note 10, Form 8-04(1) Cl.5.

[46] Id., Cl. 8.

[47] Compare Kemp: Mass Marketed Software: The Legality of the **FORM** License Agreement, 48 Louisiana Law Rev., at 88 *et* seq.(1987); Einhorn: The Enforceability of "Tear-Me-Open" License Agreements, 67 Journal of the Patent

refuse to enforce such licenses either as a matter of contract law (the lack of assent of the purported licensee) or because their terms are inconsistent with federal laws, the software industry has been lobbying several state legislatures to enact laws validating shrink-wrap transactions. In 1984, the first statute of such nature went into effect in Louisiana.[48] The enactment provides that an acquirer of mass-marketed software enters into a license agreement on terms formulated by the supplier upon opening a package. The Louisiana law validates the following terms of the license:

a) stipulations for the retention of title to the software by the licensor;
b) prohibitions against "reverse engineering", copying, modifying and adapting the software;
c) prohibitions against assignment, rental or other disposition of the software and
d) stipulations for the automatic termination of the agreement if any license term or condition is breached by the licensee.

The Louisiana statute was challenged soon after its entry into force. A district court decision held that several of its provisions are preempted by the federal Copyright Act and the ruling has been upheld by the court of appeal.[49] The court held that the Louisiana Software License Enforcement Act created a perpetual prohibition "against copying any computer program licensed pursuant to its provisions".[50] Thus, it clashed with the archival copies exemption of Section 117(2) of the Copyright Act, which was established by Congress for users of software. Furthermore, the opinion states that the statute has touched upon the area of the federal patent and copyright laws by permitting a software producer to prohibit the adaptation of a licensed program by reverse engineering.

Vault raises an interesting and controversial question. To what extent, if at all, does its rationale apply to normal licensing agreements that are not contracts of adhesion? The argument that the conflict between state laws enforcing covenants prohibiting all forms of reverse engineering and adaptations and federal laws propagating dissemination of ideas and competition should be resolved in favor of the latter laws is consistent with some U.S. Supreme Court decisions, but there are also precedents established by state and federal courts enforcing perpetual prohibitions on licensees of trade secrets that are justified in the name of the parties' autonomy and freedom of contract.[51]

Office Society, 509 (1985); Stern: Shrink-Wrap Licenses of Mass Marketed Software: Enforceable Contracts or Whistling in the Dark? 11 Rutgers Computer and Technology Law Journal, 51 (1985).

[48] 51 L.S.A. && 1961-1966. A similar statute was passed in Illinois but it has been repealed recently.

[49] Vault Corp. v. Quaid Software, 847 F.2d 255 (5th Cir. 1988).

[50] Id. at 763.

[51] See further a review of case law in this field by Soltysinski, *supra* note 6, at 469 - 470.

4. Sales and Computer System Agreements With End Users.

As already mentioned, "pure" software transactions take the form of "license" or "lease" to enable the supplier to retain the title to the marketed intangible. And as long as the rationale of **Vault** is not extended by courts to normal contracts which are actually negotiated by users of software, licensors will be able to circumvent & 117 of the Copyright Act, which authorizes the owner of a copy of a computer program to make or to authorize the making of another **copy** or **adaptation** of that computer program without the permission of the copyright owner.[52] Because the statutory privileges are granted to "owners", instead of "lawful possessors"[53] of copies of programs, licensors and lessors of computer programs forbid their clients to exercise their rights by inserting appropriate contractual prohibitions into their agreements.

For the foregoing reasons, acquisition of software in the United States and elswhere is typically conducted through licenses (leases) rather than through various forms of sales-like transactions.[54] The latter arrangements typically comprise the delivery of hardware, software or services. The majority of reported cases deal with such mixed transactions involving the sale of hardware, including its system software, combined with the sale or licensing (leasing) of application software needed by the purchaser. In addition the transaction may cover the provision of maintenance and support services. These complex contracts are usually denominated as **"computer system"** or **"turnkey"** agreements.[55]

A review of the recent case law confirms the proposition that courts apply Art. 2 of the UCC to the overwhelming majority of software acquisition contracts either directly or by way of analogy. The Code provisions on "sales" govern not only mixed transactions involving software and hardware but also the lease-purchase of computer software.[56] **Customized** computer programs have been also classified as **"goods"** for the sole purpose of allowing the court to apply Art. 2

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[52] United States Code, & 117 (1989).

[53] Such a solution was recommended by CONTU prior to the 1980 revision of the Copyright Act. There seems to be no rational argument to treat differently licensees and lessees of computer program copies and to deprive them the privileges of making back-up copies and adaptations.

[54] This typology does not include software services agreements (e. g. batch processing agreements, remote processing service or professional services agreements).

[55] Schachter *supra*, note 1 , at i.

[56] Triangle Underwriters, Inc v. Honeywell, Inc. 457 F. Supp.765 (EDNY 1978); RRX Indus., Inc., Lab-Con, Inc. 772 F2d 543 (9th Cir. 1985); Neilson Business Equip. Center, Inc. v. Monteleone, 524 A.2d 1172 (Del. 1987) (lease for a turnkey system).

of the UCC to such transactions.[57]

The application of Art. 2 of the Code to the majority of computer-related transactions means, *inter alia*, that the following practical aspects of such agreements are governed by the proper state law on sales:

1) warranties,
2) remedies for breach,
3) disclaimers and limitation of remedies,
4) mergers and integration clauses,
5) statute of limitations periods, and
6) "vouching in" rules.[58]

We have discussed some of these issues in the context of software licensing agreements (*supra*, items 2 and 3). To avoid repetition, this section of the report will examine only selected new issues against the background of recent court decisions in software **sales** transactions.

The Code creates an implied **warranty of merchantability** (& 2-314) which requires that the product be of reasonable quality and fit for its ordinary uses. Some commentators argue that the standard of "merchantability" cannot meaningfully be applied to software transactions because computer software are so diverse that they cannot be properly described for the purpose of defining their quality characteristics or minimum functions the program can be expected to perform.[59] Although this statement seems to be disputable, it is interesting to observe that there are very few court decisions in which software vendees prevailed in a suit for breach of warranty of merchantability. Similarly, software vendors frequently prevail in actions involving allegations of breach of warranty of **fitness for a particular purpose** (& 2-315 of the UCC). A case-by-

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[57] Compare Graphic Sales, Inc. v. Sperry Corp., 824 F2d 576 (7th Cir. 1987). It is worth mentioning that the UCC does not regulate a contract for work (Werkvertrag). Therefore, the statutory model of **contract of sale** remains the only **"contractus nominatus"** that serves the parties to software transactions and judges as a source of legal guidelines how to regulate warranties, disclaimers and other aspects of similar agreements. The situation is different in civil law countries where parties and judges must choose among several types of codified contractual transactions.

[58] "Vouching in" provision of the Code provides that, when buyer is sued for breach of warranty for which his seller is responsible, the former may give the latter a notice of litigation and seller will be bound by the result of the litigation if he does not come in to defend the litigation (& 2-607[5]). Compare Step-Saver Data Systems, Inc. v. Wyse Technology, Inc., 912 F.2d 643 (3rd Cir. 1990) (vendor computer systems sued its hardware and software suppliers seeking a declaratory judgement that they were liable if certain actions filed by its customers established defects in "products" acquired from the suppliers by plaintiff).

[59] Durney, *supra* note 35, at 522.

case analysis of UCC software litigation reveals that vendors successfully rely on warranty **disclaimers** not only in **implied** but also in **express** warranty disputes. The latter form of warranties can be created both by agreement and any affirmation of fact or promise made by the seller that constitutes part of the bargain (& 2-313 of the Code). Typically, any description of the quality or function of a computer program may become classified as an express warranty (e.g. a representation that a program has an on-line response time or that a system is adaptable for a specific type of business).

While in "normal" sales transactions, courts have generally not allowed vendors to rely on disclaimers to disavow their written or oral **express warranties**, in the majority of computer-related cases, they have reached the opposite conclusion.[60] Thus, for instance, in **Westfield Chemical Corp. v. Burroughs Corp.** the court held that an express assurance concerning the time saving of a computerized accounting system was effectively disclaimed.[61] Similarly, in **Jaskey Financing and Leasing v. Display Data Corp.** the court ruled that a conspicuous and properly worded disclaimer, effective against **implied warranties**, precluded oral **express** representations that the sold software system was adaptable to the buyer's type of business.[62]

The minority view exemplified by **Consolidated Data Terminals v. Applied Digital Data Systems**[63] rejected the seller's proposition that the disclaimer of "express and implied warranties" should override an express representation relating to the operating speed of a line of terminals sold to the purchaser. The author of a law review lists, *inter alia*, the following obstacles facing purchasers of computer systems under U.S. law:

1) seller's ability to limit or disclaim warranties,
2) limitation of consequential damages,
3) buyer's failure to effectively reject defective goods or to particularize the defects and
4) the shortening of the statute of limitations.[64]

Industry surveys indicate that "sales" of computer systems are subject to the same kind of warranty standards as licenses and leases of software. Typically, suppliers of software grant limited warranties ranging from 30 to 120 days of duration. Suppliers of custom-made software give usually longer warranties. One

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[60] See generally, Chretien-Dar, *supra* note 42, 488-492.

[61] 21 UCC Rep. Serv. 1293 (Mass. Dist. Ct. 1977).

[62] 564 F. Supp. 160 (E.D. Pa. 1983).

[63] 708 F.2d 385 (9th Cir. 1983).

[64] See Chretien-Dar, *supra*, note 42 at 498. & 2-725 of the Code provides for a four-year statute of limitations but the term can be shortened to one year.

year warranties are not uncommon.[65]

In practice, seller's obligations are usually reduced to **"fix or replace"** duty. The following language is recommended by ADAPSO sample form:

> If ABC is unable to replace defective documentation or media or if ABC is unable to provide a corrected computer program or corrected documentation, ABC will at its sole and exclusive option either replace the computer program with a functionally equivalent program or refund the fees paid for licensing the computer program without charge.[66]

Legal analysts emphasize that until recently courts were decisively biased in favor of the suppliers of computer programs because of the "infant industry" argument. At present, many legal analysts, consumers and even the software industry recognize the need to enhance the protection of users and condone misrepresentation by suppliers of computer programs. The software industry, without conceding the issue, is advising its minicomputer segment to take into account the potential applicability of The Magnuson-Moss Warranty Act[67] to microsoftware transactions. The Act applies to "consumer products" and imposes certain mandatory obligations on sellers of such merchandises.

To sum up, U.S. laws governing the acquisition of software is still biased in favor of the seller and therefore foreign importers of American software should be aware of many potential legal traps associated with the application of the UCC to their transactions. In arm's-length transactions, if they cannot agree on the choice of a more fair legal system, they should seek advice of an expert in the law of the exporter.

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[65] A survey by International Data Corporation found that more than 50 per cent of those interviewed gave 12 month warranties.

[66] Daunt: Warranty Drafting Aid, ADAPSO, at 8 (1985). Alternatively, the author recommends a "money back" guarantee: "If the computer program does not perform substantially with the documentation ABC will refund the fees paid for licensing (or the purchase price if the computer program is sold) the computer program". Id. at 9.

[67] 15 U.S.C. && 2301-12 (1990).

CHAPTER TWO: RECENT DEVELOPMENTS IN THE EEC

1. Introduction

The second part of this report is devoted to a succinct review of recent legal developments in the EEC. The evolution of national laws is illustrated mainly with references to jurisprudence and practice in Germany. Germany has the richest collection of judicial precedents in this field. Moreover, the dominant trend of the case law in that country is rather well-balanced. By and large, German courts take into account reasonable expectations and justified interests of both the suppliers of software and users thereof. This point seemed to be relevant from the perspective of the Regional Network for Microelectronics in the Economic Commission for Latin America and the Caribbean (ECLAC) region.

Importers and users of technology from Latin American and Caribbean countries are advised to examine and adapt various European model laws and general conditions for the acquisition of computer programs. The following sections of the report contain numerous references to the Conditions for Supply of Licensed Software Packages to Government Users in the UK (the UK Government Procurement Conditions 1987) and similar general conditions being in force in Germany.[68] Those standard forms and general conditions establish **de facto** legal standards and are more even-handed than contractual forms elaborated by the software industry.

2. Licensing of Software and Computer Systems.

a) General Considerations.

Unlike in the U.S. or. U.K. where, apart from codification of sales laws, the remaining contracts are almost exclusively the domain of general law of contract, in Germany, as in many civil law countries, the Civil Code (BGB) regulates a number of typical contractual transactions (**contracti nominati**). As a result, classification of a given transaction under a specific rubric (e.g. "sale", "barter", "lease", etc.), entails important practical consequences for the parties thereto. Specific types of contracts are subject to different standards of form, remedies, statute of limitations, etc. Transactions not regulated by the legislator are governed by general rules applicable to all contracts. Besides, such unnamed contracts can be governed by the provisions applicable to similar types of contracts regulated in the Code by way of analogy.

Intellectual property licenses are not regulated in the Civil Code. Thus, in principle, they are subject to its general rules on contractual obligations. According to the German Supreme Court, contracts for the supply of software - depending upon their content - qualify as lease (Miete), leasing, usufructuary

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[68] The German government promulgated seven general conditions for different types of contracts for supply of software products to government users. These contractual conditions are binding upon suppliers, unless expressly modified by parties. See generally, Schneider: Softwarenutzungsverträge im Spannungsfeld von Urheber und Kartellrecht, Munich (1989), 59-65.

lease, contract for work or sale.[69] Although the issue of classification of software licenses has not been finally settled, the dominant view in the jurisprudence is that they are governed by general rules of the Code applicable to contractual obligations.[70] Some commentators advocate the application of the pertinent provisions relating to lease (Miete) or usufructuary lease (Pacht).[71] As explained by the Landesgericht Stuttgart,[72] the application of the general rules gives the licensor the right to cure defects (& 326 of the Code) but extends the statute of limitation period from six months to 30 years.

In principle, software licenses are limited to situations when the marketed data are copyrightable or constitute trade secrets and when the supplier retains the title.

b) The Scope of the License.

Both in Germany and in other EEC countries, suppliers of software are essentially free to delineate the scope of the grant. Territorial, time and subject-matter restrictions are permissible within the limits permissible under the respective national and the Community antitrust rules. Like in the U.S., licensees are often expressly prohibited to copy the licensed program, except for a back-up copy, and may not adapt it for purposes not contemplated in the agreement. Furthermore, the licensee may not **rent** the licensed program to third parties.

c) Training, Maintenance and Support.

Neither English nor German law of contract implies a general obligation of the licensor to provide the licensee with free of charge training and support services. However, German courts have developed a principle that the licensor owes the licensee a duty of advice concerning the choice of the best combination of software and hardware for a concrete purpose described by the client.[73]

Model Form of License Agreement for the Use of Computer Software Products, elaborated in the UK under the auspices of the Institute of Purchasing and Supply (IPS Model L, 1987), stipulates that the licensor, shall "if applicable, install the program by the date, all as specified in App. 1". Also, maintenence and support obligations arise only "if required" (Clause 11). On the other hand, the IPS Model License is more generous to the licensee with respect to the issue of **training:**

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[69] Bundesgerichtshof (BGH) of June 6, 184 (VIII ZR 83/83), NJW 1984, 2938; BGH of February 11, 1971, Betriebsberater (BB) 677 (1971).

[70] The decision of the OLG Stuttgart of January 3, 1986, Computer und Recht, 639 (1986).

[71] Pagenberg, Geissler: Lizenzverträge, 557 (1989).

[72] *Supra*, note 69.

[73] OLG Köln, decision of March 10, 1987. CR 12/1989, at 1087.

> The licensor shall provide instruction in the use of the Program for the Licensee's personnel as specified in App.1. Unless otherwise specified no charge shall be made for such instruction but the Licensee shall be responsible for paying any travel or living expenses.

d) Responsibility for Legal Defects (Warranties of Title).

Analogous application of sales concepts or rules applicable to intellectual property licenses under the majority of European legal systems would lead to the imposition of sanctions upon the licensor in the event of "legal defects". Therefore, many software suppliers and some commentators argue that far-reaching limitations of licensor's liability should not be objectionable. Consider the following sample form:

> The Licensor is not aware of any rights of third parties which would oppose the utilization purposes of the Licensee. The Licensor is not liable, however, for the licensed software being free of rights of third parties.
>
> If the Licensee is accused by third parties of infringing intellectual property rights ..., the Licensor promises to provide the Licensee with information and documents in defense against such claims as far as the licensor is able to do so without breach of third party obligations and while maintaining its own confidentiality interests. All costs involved in such activities shall be borne by the licensee.[74]

In contrast, the IPS Model provides that the licensor shall fully indemnify the licensee against all damages (excluding **consequential** damages) incurred by reason of any infringement or alleged infringement of the licensed program subject to the following conditions:

> (i) The Licensee shall promptly notify the Licensor in writing of any alleged infringement of which he has notice,
> (ii) the Licensee must make no admissions without the Licensor's prior written consent,
> (iii) the Licensee, at the Licensor's request and expense, shall allow the Licensor to conduct any negotiations or litigation and/or settle any claim. The Licensee shall give the Licensor all reasonable assistance. The costs incurred in such negotiations shall be for the Licensor's account.

A similar copyright indemnity clause is found in the Central Computer and Telecommunications Agency and Computing Services Association Software License General Conditions (CCTA & CSA Licensing Conditions). This proves that it is a myth that a software supplier cannot undertake an effective copyright indemnity obligation.

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[74] Pagenberg, Geissler *supra*, note 71, 557.

e) Responsibility for Physical Defects. Warranties of Merchantability and Fitness for a Particular Purpose.

Although the European computer industry also stresses the point that software is never free of errors, the jurisprudence in Germany and in other EEC countries is less supplier-biased than the US case law. In Germany, for instance, the judicial concept of "physical" defects of software is much broader than in the American case law and, surprisingly, there are numerous reported cases devoted to warranty disputes there. The notion of "defect" is defined in & 459 of the Civil Code in the chapter on Sales but it is applicable to defective performance within the framework of other "named" contracts such as "lease" or "work". Since software licenses are classified usually as "lease-like transactions", we will limit our analysis to a brief examination of lessee's remedies in case of breach of warranty.[75]

According to & 537 of the Civil Code, the lessee may either suspend paying rent (in the event the product is inappropriate for the agreed use) or reduce its payment (in case the product has a defect limiting its usefulness for the agreed use). In addition, if the lessor fails to remove defects in due time, the lessee (licensee) has the right to sue for damages. In addition, the licensee may remove defects at the licensor's cost (& 538). Finally, the lessee (licensee) may rescind the contract if the lessor (licensor) failed to make the thing good within a reasonable cure period (& 542).

General conditions and sample contractual clauses frequently limit the licensee's right for breach of warranty. Major computer companies offer a full range of warranty terms. Siemens' General Terms of Software Licenses, for instance, offer three classes of warranty obligations that are subject to different price conditions: a) full warranty, including elimination of errors, b) partial warranty plus assistance in the elimination of errors and c) replacement of defective software and/or assistance.[76]

In the UK, the licensor of software typically warrants that the licensed program will perform substantially as described by the enclosed technical documentation. A contractual warranty found in the CCTA & CSA general conditions promises that:

> Unless otherwise provided in the Special Conditions, the Licensor warrants that the Product used in accordance with the Licensor's instructions will perform substantially in accordance with the operating manual ... for the duration of the Warranty Period specified in the Schedule. The Licensor does not warrant that the functions or facilities of the Product will meet the Licensee's requirements or that operation of the Product will be uninterrupted or error free.

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[75] The concept of "defect" (Fehler) will be examined in the next section of the report dealing with sale of software.

[76] Goldrian: National Laws Affecting Distribution and End-User Agreements, 13 (a paper presented at Conference: Information Technology: Trading With Europe - East and West, Munich May 31, June 1, 1990).

Similar terms of warranties are recommended by the Model Form of License Agreement of IPS.

f) Disclaimers.

European standard forms and general conditions often expressly exclude licensor's liability for consequential losses. Licensors tend to disclaim their liability for warranty of fitness. Some model forms recommend language stating that the licensee knows the licensed program and its technical capabilities.[77] However, some model agreements provide that "the licensor shall indemnify the licensee against injury to any persons or loss of or damage to any property, including the program which may arise out of default or negligence of the licensor."[78] The CCTA & CSA Conditions contain a similar provision, qualified by a ceiling of the upper amount of any liability in respect of losses and damages to property up to the amount of one hundred thousand pounds.

IMB's Standard Terms and Conditions used in the U.K. offer warranty of conformity of the licensed program with the current specifications: "All other licensed programs are distributed **as is**, without warranty of any kind, express or implied." But in the event the company is found liable for death, personal injury or for damage to tangible property its liability is unlimited. In other cases, the conditions specify contractual maximums of liability. For instance, the upper limit of compensation to be paid for a licensed program, IBM promises to pay the greater of 55,000 pounds or twelve months' charges due for the use of the licensed software.[79]

g) "Shrink-Wrap" Licenses.

As in the U.S., "shrink-wrap" licenses are widely used in Europe. They are marketed on similar terms and conditions. Thus, for instance, standard software packages offered by Image System Technology, U.K., are "licensed" subject to the following stipulations: (i) the license is made upon opening the package by the customer; (ii) it can be returned to the place of "purchase" (sic!) within 7 days to obtain a refund; (iii) the software may be operated on one computer at a time; (iv) the customer may make one back-up copy which becomes the property of the licensor; (v) software and data are provided **"as is"** and the licensor excludes all warranties, "except that the media (disk or tape) are free from defect and materials under normal use for a period of 90 days from the date of delivery."

Except for Germany, there seem to be no precedents relating to the legal qualification of "shrink-wrap" licenses or to the validity of typical restrictive

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[77] This creates an irrebuttable presumption that the licensee knew the defects at the time of delivery of the program and it excludes the suppliers liability. Compare Pagenberg, Geissler, *supra*, note 71, at 519.

[78] IPS Model Form of License (1987), Cl.16.

[79] IBM, Standard Terms and Conditions (1990), Section A, Cl. 8 B. (A form used in the U.K.).

covenants found in such standard contracts. Legal commentators agree that some "shrink-wrap" licenses can be found partially or totally unenforceable in the light of general principles of the applicable law of contract (unconscionability). In Germany "shrink-wrap" licenses and disclaimers are strictly controlled by special legislation concerning general conditions of contracts. Such licenses are valid only if they conform to the requirements of the body of case law established under the Statute.[80]

Others correctly observe that certain restrictions may conflict with the principle of **free movement of goods** within the Community or the doctrine of exhaustion of copyright. It should be mentioned that according to a decision of the Supreme Court of the Germany standard programs fixed in tangible media and distributed to the recipient for an indefinite period of use in exchange for a fixed payment are presumed to be classified as **"sales"**.[81]

Similar doubts exist in the U.K. and in France. Restrictions on reverse engineering and decompilations may be viewed as contrary to public policy. The British Copyright Act considers **"research"** as a privileged act, regardless of its purpose.[82] However, the validity of an express prohibition of such activities in the context of a contract of adhesion is an unsettled issue.[83]

Finally, it is worth noting that Section 56 of the British Copyright Act of 1988 indirectly applies to "shrink-wrap" licenses. The Act provides that, if any work in electronic form is marketed on terms that it may be copied or adapted, the right to do so passes to any subsequent transferee of any of such copies. Thus, S. 56 admits express terms prohibiting transfer or making adaptations.

3. Sales of Software and Mixed Software/Hardware Transactions.

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[80] See the text accompanying note 96 *infra*. OLG Stuttgart of February 2, 1989, CR 685 (1986). The decision conditions enforceability of disclaimers in "shrink-wrap" licenses on their conformity with rules and precedents established under the AGBG.

[81] BGH of November 4, 1987, NJW 406 (1988). However, the holding refers to cases when the standard software is conveyed for "freier Verfügung" which is translated by a German software expert as "for indefinite optional applications". Goldrian *supra*, note 76, at 9. But it can also be translated as "free disposition" and not all "shrink-wrap" licenses grant such broad permissions to the customer.

[82] Chalton: Implementing the EC Council Directive: The National Perspective from the UK, (in: Information Technology: Trading with Europe, Conference of International Federation of Computer Law Associations, Munich May 31, June 1990), at 12. Similar view dominates in the French jurisprudence. Michau: The French Perspective of the EEC Directive, 5 (the Munich Conference, *supra*).

[83] See further discussion on the issue of "reverse engineering" under the future EEC Council Directive. Section 5 *infra*.

a) Problems of Classification.

Although the problem of legal classification of software acquisition contracts in EEC countries has not been settled, there is a growing tendency to treat many transactions in **standard software** as sales or sales-like agreements. In Germany there are several Supreme Court decisions recognizing software acquisition contracts as sales when the data are incorporated in a tangible medium and the acquirer obtains the right to use only an object code.[84] A similar trend is visible in the U.K. In **Endodynamic Systems v. General Automation**, the court held that at least contracts involving both software and hardware should be treated as transactions in "goods"[85]. Furthermore, the application of the Sale of Goods Act (1979) to software acquisition contracts is rarely questioned.[86]

In Germany, mixed software and hardware acquisition contracts are often classified under the rubric of "sales". If hardware and software cannot be separated without a detriment to the client, he can rescind the whole contract even if only the software is defective. If a defective software can be replaced only by a new version of the program with which the supplied hardware is not compatible, the client can rescind the whole agreement despite the fact that the tangible element is error-free.[87] The practical difference between such unitary contracts and truly "mixed" contracts consists in that the latter are split into two or more separate parts to which different provisions of the Civil Code are applicable. For instance, a contract for the commissioning of software and acquisition of a suitable hardware equipment was held a mixed agreement governed by the Code provisions relating to contract for work (Werkvertrag) and sales (Kauf).[88]

b) Warranties for "Physical" Defects.

After a short period of doubt it was accepted that the Code concept of "defect" is applicable to software transactions. Indeed, especially German courts have demonstrated their tremendous capacity to adapt the Code rules on breach of warranty in this field. Section 459 of the Code states that a thing sold shall be free of defects that reduce its value or usefulness for ordinary use or its fitness for the purpose contemplated in the agreement.

The German case law generally applies very strict standards to the seller's obligations relating to the functionality and usefulness of software. Judges

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[84] BGH of May 2, 1985, GRUR, 1055 (1985); BGH of November 4, 1987, *supra*, note 81. See further Hoeren: Der Softwareuberlassungsvertag als Sachkauf, CR, 908 (1988).

[85] As reported in Applied Computer and Communications Law, v. 5, at 58 (1989).

[86] Compare Goode: Commercial Law, 154 (1985).

[87] Landesgericht Berlin, decision of February 2, 1987, IuR, 424 (1987).

[88] LG Augsburg of November 11, 1985: IuR 166 (1986).

found defective performance by the seller of software in the following circumstances:

(i) unclear documentation,[89]
(ii) lack of compatibility between error-free software and hardware recommended by the seller,[90]
(iii) lack of a signal indicating that a diskette is defective,[91]
(iv) lack of proper instructions; manuals shall be translated into German;
(v) the use of a program "lock" is permissible but it constitutes misuse if the buyer is not informed about its presence and the seller uses the device to "persuade" the client to buy additional products.[92]

German courts apply rather strict standards to the consulting obligations of the supplier of software, especially with respect to consumers. Furthermore, judges are eager to find the existence of a representation of promised characteristics of a sold program by the seller. The lack of the promised characteristic of the "merchandise" is treated as a "defect" (& 463 of the Code). Such a warranty of "compatibility" can be granted not only by way of express representation but it can be implied when the seller knew the purpose of the contemplated application of the purchased program.[93]

c) Remedies for Breach of Warranties and the Impact of General Conditions.

Remedies for breach of warranties under German law include the right to rescind the contract and claim only transactional damages (& 276 of the Code). Full damages are available only in the absence of "promised characteristics of a thing" (zugesicherter Eigenschaften). From the buyer's perspective, the Code system of liability for defective performance in the framework of sales law has two disadvantages. First, it has a very short statute of limitation period (six months). Second, the buyer does not have a right to demand correction of defects.

The visible improvement of the legal position of the buyer vis-a-vis the seller of software products in EEC countries is partially due to a concerted action of large-scale software users and consumers. Apart from general conditions for the delivery of computer hardware and software for government agencies, the associations of users of computer programs from the EEC have elaborated a Model

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[89] KG Berlin of November 24, 1985, CR 643 (1986)

[90] OLG Celle of February 26, 1986, CR 303 (1988).

[91] OLG Köln of June 22, 1988, NJW 2477 (1988). The same holding applies when a program defect is signalled but without explaining the cause thereof.

[92] LG Stuttgart of January 3, 1986, CR 639 (1986).

[93] OLG Saarbrücken of May 30, 1990, CR 713 (1990).

Law for the Acquisition of Computer Equipment.[94] The CECUA Model Contract applies also to mixed transactions involving software. Although a comprehensive evaluation of the Model Contract is beyond the scope of this report, we will briefly characterize its key provisions pertaining to the matters examined in this study.

First, the CECUA Model Contract defines and stresses the importance of the parties' mutual obligations during the installation of an ordered computer system (Cl.4-11). The supplier is obliged to familiarize himself with the requirements and local conditions at the installation site. Furthermore, he is bound to give the client necessary advice and check his actual needs with respect to the ordered equipment (Cl.4). Second, following the delivery and installation of a system, the supplier shall conduct necessary tests of all delivered hardware and software elements of the package. Copies of such tests shall be made available to the buyer (Cl.13). Third, the supplier warrants that hardware and software are free of design, execution, function, workmanship and material defects and that they conform to the published specifications and contractual terms and conditions (Cl.15). Fourth, the supplier shall deliver all necessary programs and shall guarantee the client access to software improvements during 7 years following the delivery of the system. Fifth, the supplier warrants that all elements of the system are mutually compatible and he shall not modify any interfaces without a written permission of the client. Sixth, the supplier is obliged to deliver all necessary documentation and user's instructions (Cl.21).

Sanctions for breach of warranty of title and warranty of defects are stricter than under the Code or typical seller's general conditions for the supply of computer systems. The period contractual guarantee is de minimis 12 months and the client has the right to demand specific performance (repair) or he is authorized to cure the defect with the help of a third party at the risk and cost of the supplier (Cl.23). The supplier is obliged to defend the client at his costs against third party claims for alleged or actual infringement of intellectual property rights, including infringement of trade secrets and to reimburse all costs incurred by the buyer therewith (Cl.30).

A commentator stresses the fact that the CECUA Model Contract is rather unpopular among suppliers but it serves as an educational tool for clients who negotiate computer contracts.[95] Furthermore, some suppliers have introduced specific provisions of the Model Contract to their general conditions. Finally, the CECUA Standards are more and more accepted by courts.[96]

Of course, standard forms and conditions used by suppliers of technology are

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[94] The model contract was published in Germany and is generally known as "CECUA - Standard Contract" (Modellvertrag für den Kauf von Computeranlagen und -Geräten).

[95] Schneider, *supra*, note 68, at 64.

[96] See, for instance, the decision of LG Düsseldorf of 1987, CR 292 (1987), in which the court held that the supplier is obliged to get acquainted with the production requirements of the customer when writing an individual program.

less friendly to the "buyer". It is worth stressing, however, that in some EEC jurisdictions such contracts of adhesion are controlled by special legislation. In Germany, for instance, the Law on General Conditions of Contracts[97] prohibits a number of clauses which are deemed to be oppressive to clients and, therefore, they are either null or unenforceable. For instance, a disclaimer of the right to rescind the contract in the event of seller's failure to repair the sold software was held unenforceable.[98] Likewise, OLG Hamm ruled that a clause aimed at establishing a fiction that the delivered software was accepted by client immediately upon its delivery, was aimed at shortening a mandatory test period for software transactions and, therefore, it was unenforceable.[99]

4. Custom-Made Software and Peculiarities of Contract for Work (Werkvertrag).

The providers of customized software or computer systems are subject to stricter rules than suppliers of standard products. In many respects such transactions are subject to similar legal standards as those applicable to sales and licenses (e.g. the notion of "defect", warranties of title, disclaimers, etc.). However, courts have developed some peculiar rules in this field.

In civil law jurisdictions in which "sales" and "contracts for work" are governed by separate chapters of the applicable code. In Germany, for instance, the basic difference between the two legal regimes consists in that the principal remedy of the employer in the event of defective program consists in the right to demand repair (& 633 of the Civil Code) rather than in rescission of the contract. The right to rescind the contract (Wandlung) arises, in principle, only if the contractor fails to repair the work within a reasonable cure period (& 634). Finally, if the contractor is in delay, the employer (client) may repair the work at the supplier's cost. National laws may provide divergent warranty and statute of limitations periods for "sales" and "contracts for work".

Several judicial decisions in Germany characterize transactions for writing custom computer programs as **"contracts for work"**.[100] Also, mixed transactions covering hardware, software and services are classified as "works" if the **dominant** element of the transaction consists in creating a specified tangible or intangible work (result).[101] A contract for the elaboration of a computer program (software) has been classified by the Supreme Court of Germany as **"Werkvertrag"**.[102]

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[97] Gesetz über Allgemeine Geschäfts Bedingungen (AGBG).

[98] LG München of January 23, 1985, (IuR 72 (1986)).

[99] Decision of December 12, 1988, (NJW 1041 (1989).

[100] BGH of February 11, 1971, BB 677 (1971); OLG Oldenburg of February 12, 1986, CR 552 (1986).

[101] See BGH of July 24, 1986, CR 799 (1986).

[102] BGH of January 30, 1986, CR 377 (1986).

In many European countries copyrightable programs developed within the framework of contracts for work, R&D or consulting agreements belong to the developer (contractor), unless recent modifications of copyright laws introduced the opposite solution. Of course, the parties to a software development agreement may provide otherwise.[103] Because the developer of software usually owns the title to the program, commentators and courts are divided on such issues as to whether the employer (the client) has the right to demand the delivery of the **source code** of the commissioned software. According to a recent decision of the Munich Court of Appeal, a developer of software under an individual contract was obliged to deliver the source code to the client if the parties had not concluded a maintenance and support agreement.[104] The opinion explained that since the client had to care for maintaining the program, he needed the source code and the developer's duty to deliver it was implied under the circumstances. The decision is consistent with an earlier opinion of the Supreme Court which had refused to uphold a similar demand of the client where the developer was obliged to provide maintenance and support services during the contract.[105] The duty to deliver a source code is also stipulated in the Government Special Conditions for the Development of Computer Programs of January 21, 1986.[106]

The legal status of prohibitions against adaptations and self-repair by the client is uncertain. Software developers frequently include such provisions which, while supported in copyright laws and the general law of contract, might be held by courts as practices restraining competition or against public policy.[107] A German district court ruled that the client is authorized to make the necessary adaptations of the acquired program, unless the contract provides otherwise.[108] The permissible scope of adaptations is limited by the purpose of

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[103] But even in France, it is advisable for the developer to include an express provision that he retains ownership in the program. An example of such a stipulation reads: "All instructions, procedures and computer programs first made by Contractor in the course of developing the software to be furnished to the company remain the property of the Contractor. The Contractor may use the entirety of information and knowledge which he may acquire in the course of development of the software." Muenchinger: Who Owns Software Developed Under Contract? The French Perspective, E!PR 311 (1986). In BMW v. Pachot, a fired ex-employee prevailed in a suit against his former employer over the issue of the ownership of a program developed by the former without any assistance from his employer but with the use of processing cards removed temporarily from his work place. Cour de Cassation, March 7, 1986, as reported by Muenchinger. Id. at 307.

[104] LG München of November 18, 1988, NJW 2625 (1989).

[105] BGH of January 30, 1986, NJW 1259 (1987).

[106] Besondere Vertragsbedingungen fur das Erstellen von DV-Programmen, as published in Heussen: Computerrechts Handbuch, 1 (1990). hereinafter referred to as "BVB Conditions".

[107] Goldrian, *supra*, note 76, at 6.

[108] LG Munich of February 17, 1987, CR 379 (1988).

the agreement. The court explained that such interpretation is consistent both with the general principles of interpretation of contracts and & 39(2) of the German Copyright Act which allows adaptations of a work if it is not contrary to **bona mores**.

In **Saphena Computing v. Allied Collection Agencies**[109], an English court indicated that the commissioner of custom software may be authorized to repair the program if it has legally obtained the source code from the defendant. Making available the source code amounts to an implied license to copy it "for the purposes of their business, including repair of improvement of the object code."[110]

Foreign importers of software and computer systems should study the German "BVB Conditions" (1986).[111] They classify contracts for the development and supply of computer systems as contracts for work and are similar to the CECUA Model Law. They provide, *inter alia*, for a minimum 12-month guarantee period, broadly defined right of use of the program and effective remedies in case of breach of warranties. Apart from the Code remedies, the Conditions stipulate for penalties in the event of contractor's delay.

As a rule, disclaimers in contracts for work are treated in the same way as exculpatory clauses in other software acquisition contracts.

5. The Implications of the EEC Commission Draft Directive on the Legal Protection of Computer Programs.

The proposed EEC Directive on the Legal Protection of Computer Programs has generated a flood of controversial opinions which epitomize the two contrasting policy approaches in this field. At the risk of oversimplification, the dispute can be summarized as follows: Big computer companies led by U.S. dominant companies like IBM and Apple stress the need to grant software producers the maximum of protection. They are in favor of cumulative protection of computer programs under copyright and trade secrets laws and are against "reverse engineering". They have formed a lobbying group known as Software Action Group for Europe (SAGE). The second camp, composed of medium-size and small companies, computer users and academics, has organized the European Committee for Interoperable Systems (ECIS), favors free competition and a weaker protection of software innovations, consistent with the traditional copyright principles of freedom of exploitation of ideas and dissemination of knowledge.

The gist of the ongoing debate focuses on the legality of "reverse engineering" and the freedom of access to **computer interfaces**. The proponents of the pro-competitive approach (ECIS) argue that the Directive must expressly permit research by means of decompilation (disassembling) software in order to

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[109] Official Referee's Court of April, 25 1988. 59 Computers and Law 20 (1988).

[110] Id.

[111] *Supra*, note 106.

allow access to existing interface specifications and algorithms.[112] The proponents of the opposite view opine that reverse engineering is contrary to the Berne Convention and, as a matter of policy, it would encourage "piracy" and "free riding".[113] Indeed, the latter approach, if adopted, would strengthen the dominant position of large computer firms and stifle innovation. This view prevails also among small and many medium-size firms in the U.S.

Members of the ECIS stress that European firms would be at a disadvantage at "home" because "reverse engineering" is permissible both in Japan and in the U.S.[114]

While the courts and legal commentators in the U.S. are divided on this issue[115], Japanese judges and leading commentators take a more moderate and less protective strategy to the protection of software. It is worth noting that Japanese courts are likely not only to legitimize "decompilation" but also to reject the famous Whelan approach, which held that a computer program is protected against substantial copying of the so-called "structure, sequence and organization".[116]

It is expected that a compromise will be reached along the following lines: Reverse engineering will be permissible but subject to substantial restrictions.

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[112] Cornish, Interoperable Systems and Copyright, EIPR 391 (1989); Colombe, Meyer: Interoperability Still Threatened by EC Software Directive: A Status Report, EIPR 325 (1990).

[113] Lake et al.: Seeking Compatibility or Avoiding Development Costs? EIPR 43 (1989); Burkill: Reverse Compilation of Computer Programs and its Permissibility Under the Berne Convention, Computer Law and Practice 114 (1990).

[114] This view is essentially true although the matter is controversial in those two countries, too. See Soltysinski, *supra*, note 6, 468-469; Durney: Reverse Engineering Under Japanese Law, Intellectual Property, Marketing and Community Law, 2 (1990). The author cites Japanese authorities for the proposition that under the Japanese Copyright Act "reverse engineering" is permissible. Furthermore, he explains in detail that a recent decision in Microsoft Corp. v. Shuuwa System Trading KK of January 30, 1987, which is interpreted by some partisans of the SAGE camp as allegedly outlawing "disassembling" of software, did not even discuss that issue. Id. at 3. See further, *infra*, note 115 .

[115] Contrast Whelan Inc. v. Jaslow Dental Laboratory Inc. 797 F2d 831 (1987) and Apple Computer Inc. v. Franklin Computer Corp. 714 F2d 1240 (3d cir. 1983) with NEC Corp. v. Intel Corp. 10 USPQ 2d (ND Cal. 1989). The latter decision found "reverse engineering" unobjectionable.

[116] Compare System Science Corp. v. Toyo Sokki KK, Tokyo Dist. Ct decision of 31 March 1989, commented by Karjala: Japanese Courts Interpret the Algorithm Limitation on the Copyright Protection of Computer Programs, 7 European Intellectual Property Rev. 235 (1990). See also Karjala: The First Case on Operating Systems and Reverse Engineering in Japan, 10 EIPR 172 (1988).

It is recently proposed by the EEC that the decompilation can be used to make a compatible program but not to develop a directly **competing product**.

The Commission's amended proposal submitted to the European Council pursuant to Art. 149 of the EEC Treaty restricts the application of the "reverse engineering" privilege to those parts of the original program "whose function is to provide for its interconnection with other elements in a system":

> 1. Notwithstanding contractual provisions to the contrary, the authorization of the owner of the rights shall not be required where reproduction of the code and translation of its form are indispensable to achieve the creation, maintenance or functioning of an independently created interoperable program provided that the following conditions are met:
> a) those acts are performed by the licensee or by another person having a right to use a copy of a program, or on their behalf by a person authorized to do so;
> b) the information necessary to achieve interoperability has not previously been published, or made available to the persons referred to in subparagraph a); and
> c) these acts are confined to the parts of the original program that are necessary to achieve interoperability with it.[117]

The Commission's amended proposal does not follow the much broadly worded "reverse engineering" exception recommended by the European Parliament which allowed it also for the purpose of ensuring the **maintenance of the program**.[118] On the other hand, the Commission has followed the Parliament's suggestion that the Directive should expressly allow a legitimate use of a program - without the authorization of the right-holder - to "observe, study or test the functioning of the program in order to determine the ideas, principles and other elements which underlie the program and which are not protected by copyright" (Art. 5 (5)). Furthermore, the proposal incorporates the so-called principle of **"exhaustion"** of a copyright according to which the right to control the distribution of a program shall not be available after its first sale and importation by the right holder or with his consent (Art.4 (c)). The practical significance of the latter provision may be marginal because standard software is usually **licensed** rather than **sold**.

The last text of the EEC proposals contains a reference to programs **"sold"** or **"licensed"** (Art. 5). The proposal provides that all acts necessary or incidental to the use of the program purchased under such circumstances shall be permitted. In a nutshell, Art. 5 prohibits contractual restrictions on use and allows translation, adaptation and other alteration where they are necessary for the use of the program by the **lawful acquiror** in accordance with its intended purpose.

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[117] Commission of the European Communities, Amended Proposal for a Council Directive on the Legal Protection of Computer Programs of October 18, 1990, COM (90) 509, at p. 28.

[118] See Official Journal of the European Communities, No. C 231/78 of September 17, 1990, Art. 5 A.

By contrast, a **licensee** benefits from the same rule if the contract does not contain specific provisions dealing with such acts (Art. 5(2)). It remains to be seen whether the Commission and the European Court will tolerate restrictive use limitations clauses in shrink-wrap and other software licenses.

To sum up, the expected EEC Directive on the Legal Protection of Computer Programs will probably legitimize limited "reverse engineering" and improve the position of "purchasers" of computer programs, thus strengthening to some extent the bargaining position of smaller computer companies and users of software both in Europe and elsewhere.

Chapter III: Problems Peculiar to Transnational Transactions.

1. General Considerations.

The last part of this report sketches issues that are peculiar to transnational software acquisitions contracts. It has been prepared in order to highlight typical problems that may arise in **import** transactions concluded by microelectronics industries from the ECLAC region with suppliers from the U.S., the EEC or Japan.

International transfer of technology transactions are similar to domestic agreements but they also involve special issues not present in agreements between firms located within the same jurisdiction. Parties to international transactions should take into account differences in their local laws, government controls of exportation/importation of software, international tax and antitrust aspects of the contemplated deal, choice of law and choice of forum and implications of the distance dividing the parties to the transaction on their mutual rights and obligations.

Typically, since exportation of the majority of software and hardware requires an export license, the parties to a transaction should expressly provide that all formalities and licenses required in the country of exportation shall be arranged by the exporter. Similarly, the importer of software should be responsible to obtain the necessary import licenses in his country. In addition, because many Latin American countries have transfer of technology import regulations, the importer should familiarize the exporter with pertinent rules in the recipient country.

Parties to transnational transactions are advised to define all key technical and legal terms used in their contracts and properly characterize the legal nature thereof. Ideally, the classification of a given acquisition of software contract should fit the applicable categorization in the law of the recipient country and in the law chosen by the parties to govern civil law consequences of the arrangement. Because of the differences among national laws, it is necessary to define even such standard legal concepts as **"exclusive license"**. In some countries this term means that the licensor cannot compete with the exclusive licensee in the licensed territory (e.g. in the U.S.). By contrast, in France an exclusive licensor is only obliged not to grant another license within the same field to a third party.

The distance dividing the parties has an impact on the formulation of maintenance and support obligations as well as on the clauses dealing with the transfer of risk when the goods are in transit. The importer of software or computer systems is advised to try to acquire the products on CIF terms or to allocate delivery costs between the parties. The ideal solution for the importer would be to negotiate the following clause:

> Exporter shall assume all risks of loss or damage to the imported Program (Computer System) while in transit and cover all costs of transportation

between the Exporter's factory and the port of destination.[119]

Of course, exporters of technology are reluctant to offer training, support and maintenance services in distant countries, unless they have their local representatives there. Therefore, importers should carefully negotiate a minimum of support and training. The agreement should specify the number of days or weeks provided for technical training, installation and additional support. A relatively cheap form of support consists in providing such services by phone, telex or fax. Access to the exporter's support center should be available on a round-the-clock basis, or de minimis, during the importer's working hours. Consider the following clause:

> During the term of the Agreement, Exporter shall provide Importer with assistance by telephone (fax) regarding the installation, use and maintenance of the Imported Product. Exporter shall reimburse Importer for all costs incurred by it in connection with defective performance of the Product or insufficient explanation of its operation and maintenance in the enclosed Materials.

2. Choice of Law and Choice of Forum.

Even experienced lawyers tend to insist that their domestic laws shall govern international transactions entered into with foreign parties. Familiarity with one's own legal rules is certainly an important factor in this context but it is by no means clear that such a choice is the best option for the partisan of his domestic law. If the parties cannot agree which of the two competing systems should govern their relationship, they often choose a "neutral" legal system. Unaware importers from developing countries often agree to choose Swiss law which allegedly epitomizes the most neutral legal solutions. In reality, however, Swiss law strongly favors the stronger, professional party, especially the exporter of technology. In the absence of choice of law, Swiss conflict-of-laws rules apply the law of the exporter of technology and this choice reflects a deliberate policy of encouragement of suppliers of technology to choose Swiss law and Swiss forum.[120] Swiss Law of Obligations seems to be the most liberal codification of the law of contract which favors freedom of contract thus permitting the "seller" of technology to exploit his bargaining position.[121] Of course, Swiss law and Swiss forum are strongly recommended whenever firms from the REMLAC region export their computer products abroad.

The foregoing review of the recent developments in the contractual practice in the United States of America and in the EEC clearly indicates that the

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[119] Naturally, exporters of software systems propagate the opposite solution. See Palenski: Exclusive Distribution Agreement (International), 6 (1983) (ADAPSO FORMS).

[120] Compare Loi fédérale sur le droit international privé of December 18, 1987, Art.122.

[121] See further Soltysinski: Choice of Law and Choice of Forum in Transfer of Technology Transactions, Recueil des cours, 307-323, 345-347.

European case law is far more even-handed and more sympathetic to the recipient of computer products. Within the EEC, German law is probably the most advantageous to the buyer (licensee) of software products. Thus the selection of German law is recommended to Latin American importers of software.They should also translate into Spanish (Portuguese) and use during negotiations the various general conditions for the acquisition of software elaborated in the EEC by users of software. Members of the Regional Network for Microelectronics in the ECLAC Region should consider adaptation of the German Government software procurement general conditions, examined in Chapter II of this report.

While negotiating contracts with U.S., European and Japanese firms, importers from Latin America and Caribbean countries should consider choosing the laws of such countries as the Netherlands, Sweden or Austria. It is important to mention that the Austrian Statute of Private International Law, unlike its Swiss counterpart, provides that in the absence of choice of law, transfer of technology transactions shall be governed by the law of the country for which territory a license was granted.[122] This law may become applicable to a software import transaction if the parties agree to arbitrate in Vienna, leaving open the question of the law governing their contractual relationship. In such a case the arbitral tribunal shall apply the conflict-of-law rules of the forum.

While acquiring standard software packages in the U.S.A., Japan or Europe, foreigners should carefully check the geographical scope of the "shrink-wrap" license and other terms of the transaction. Frequently, the recipient of such standard computer programs and materials may discover that he acquired the right to use the copyrighted materials only in the country where the transaction was made or that warranty remedies are available only in that country. In such cases, the acquirer (e.g. the licensee) should request an express statement from the supplier of the licensed software that would modify the geographical scope of the license and the terms of enforcement of key contractual remedies. Usually, it is enough to obtain the following representation by the seller (licensor) on the back of the invoice:

> The licensor hereby expressly declares that it is aware that the licensee will use the acquired program in [the name of the country of exploitation of the program] and grants him the right of use, as defined in the enclosed "Terms and Conditions of License", in that country. All warranties and other contractual rights provided in the aforementioned "Terms and Conditions" will be available to the licensee, except that the licensor will not be responsible for providing services concerning [e.g. installation or support, as defined in Sec..].

Importers of technology from the REMLAC region should consider selecting one of the small arbitral centers such as Vienna, Stockholm, or Rotterdam. They are cheaper than Swiss fora or the Court of the International Chamber of Commerce, Paris. Besides, they are located in countries pursuing strong public policies in favor of the weaker party and freedom of competition. While negotiating dispute resolution problems, importers of technology should consider a compromise

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[122] See the text of the Austrian Statute on Private International Law published in: 43 Rabels Zeitschrift 383 (1979), & 43.

solution which consists in the adoption of the so-called "home-on-home" clause. It requires the party bringing a suit to attack the defendant in his domestic jurisdiction. Naturally, such a clause encourages the parties to attempt to resolve their controversies by amicable settlement. Clauses of this type are enforceable both in Europe and in the United States.[123]

Finally, the parties to international software transactions should remember that certain matters cannot be arbitrated and that some Latin American countries subject import transactions to the exclusive jurisdiction of their domestic transfer of technology transactions and local courts. Obviously, this aspect of the problem is a matter of concern for foreign suppliers of technology.[124]

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[123] See Smith, Valentino & Smith, Inc. v. Superior Court., 17 Cal. 3d 491 (1976).

[124] See generally, Correa: Transfer of Technology in Latin America: A Decade of Control, 15 Journal of World Trade Law, 388 (1981); Soltysinski, *supra*, note 111, at 249 et seq. Recently, however, many Latin American countries have liberalized their transfer of technology laws.